SIA RESEARCH REPORTS

Vol. IV, No. 5 May 30, 2003

AFTER THE BUBBLE HAS BURST: NEW REGULATIONS FOR RESEARCH ANALYSTS IN THE U.S.

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THE NEW YORK SECURITIES INDUSTRY: WALL STREET'S IMPORTANCE TO NEW YORK STATE AND CITY

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AFTER THE BUBBLE HAS BURST: NEW REGULATIONS FOR RESEARCH ANALYSTS IN THE U.S.[1]

Recent revelations of serious misconduct by certain high profile research analysts during the boom years of the 1990s has forced securities market regulators and market participants alike to examine how conflicts of interest, particularly those arising from the production and dissemination of research, can be better managed in today's integrated financial services firms. The resolution of this issue, along with improved corporate governance standards, is seen by many as key to restoring investor confidence in securities markets. This issue has been particularly important in the U.S., where market participants, regulators, legislators and law enforcement officials have all contributed to the regulatory framework regarding research related conflicts of interest that is emerging. As a result of all these efforts, the U.S. has the most extensive regulations for research related conflicts of interest that have been proposed and implemented to date.

The new regulations for research analysts and research related conflicts of interest will improve the integrity of the research process, primarily because the incentive structure which may have encouraged the issuance of biased research in the past has been radically transformed. At the same time, the new regulations will impose significant adjustment costs on integrated financial services firms, which has already resulted in a substantial reduction in research coverage. The new regulations may also affect the capital raising process, as research analysts may no longer be able to evaluate new investment proposals. In short, the new regulations will clearly have both a beneficial impact as well some adverse effects. However, because the regulations are still evolving, it is impossible at this point to arrive at a decisive evaluation of their costs and benefits. That will have to wait until some point in the future.

1. Global Efforts and Recent Developments in the U.S.

The effort to address potential conflicts of interest affecting the production and dissemination of research by securities firms is truly a global one, with regulators in almost all developed market economies having proposed or implemented new rules for research related conflicts of interest since early 2001 (**Table 1**). In addition, the European Union recently issued two new directives that deal in part with research related conflicts of interest while the Committee of European Securities Regulators has released its proposed implementing measures for one of those directives and is working on implementing measures for the other. The European Commission has also established a Forum Group on Financial Analysts that is examining the need for additional regulations and/or "best practices" for research analysts in the European context. Finally, at the international level an IOSCO Project Team on Securities Analysts was formed in early 2001 to examine how securities regulators could address conflicts of interest faced by sell-side research analysts. The project team is currently working on the development of high-level principles that could be used as the basis for new regulations for research analysts and research related conflicts of interest in all IOSCO jurisdictions.[2]

[1] This paper is excerpted from a longer paper that covers new regulations for research analysts and research related conflicts of interest in a large number of jurisdictions. That paper is available on the International Council of Securities Associations website, located at www.icsa.bz. Please note that all opinions expressed in this article are solely those of the author.

[2] The IOSCO Statement of Principles on Security Analyst Conflicts of Interest, which a selected chairs' committee has been asked to submit to the organization's Technical Committee by September 2003, is expected to deal with the standards of disclosure of conflicts of interests, the limitation or management of such conflicts, reporting and compensation systems, the elimination of outside influence and the integrity and competence of research analysts.

Table 1
Chronology of New Rules for Research and Related Conflicts of Interest

International/Regional		
IOSCO	Report of Project Team on Securities Analysts	Late 2003
EU	Draft Market Abuse Directive issued Revised Investment Services Directive proposed Report of EU Forum Group on Financial Analysts	November 2002 December 2002 Mid-2003
CESR	Consultative Paper on Level 2 Implementing Measures for the Proposed Market Abuse Directive Advice on Level 2 Implementing Measures for the Proposed Market Abuse Directive	July 2002 December 2002
National		
Australia	Best Practice Guidelines for Research Integrity ASX publishes Draft Guidance Note Treasury issues Proposals Paper on Corporate Disclosure	November 2001 September 2002 September 2002
Canada	SICAS publishes *Report on Analysts Standards* IDA approves Policy No. 11, "Analysts Standards" IDA revises Policy No. 11, "Analysts Standards"	November 2001 June 17, 2002 December 2002
France	Conseil des Marchés Financiers Implements N°2002-01 CMF amends Articles 2-4-1, 2-4-7 and 3-2-5	March 27, 2002 May 10, 2002
Germany	Section 34B of the Securities Trading Act implemented BAFin issues Interpretive Guidelines for Section 34B	July 1, 2002 March 2003
Italy	CONSOB issues Communication DME/1029755 CONSOB amends Article 69 of Regulation No.11971/99 CONSOB issues Communication n. 3019271	April 2001 July 2002 March 2003
Japan	JSDA issues "Rules for Handling of Analysts' Reports" JSDA issues Interpretative Guideline JSDA issues revised "Rules for Handling of Analysts' and Reports" and Interpretative Guidelines	January 25, 2002 February 15, 2002 January 15, 2003
Korea	FSC amends "Supervision of Securities Business Rule" KSDA revises" Securities Company Business Conduct Rule" FSC implements Consolidated Supervisory Plan for Analysts' Conflicts of Interest KSDA issues Securities Company Business Conduct Rule, Second Edition	March 2002 May 2002 August 2002 August 2002
Sweden	SSDA Implements "Complementary Rules of Conduct" FSA Implements Regulation FFFS 2002:7-8	March 1, 2002 July 1, 2002
UK	FSA publishes Discussion Paper No. 15 FSA issues Consultation Paper No. 171	July 2002 February 2003
US	SIA publishes "Best Practices for Research" New York State Attorney General opens investigations NASD/NYSE announce new rules relating to research SEC approves NASD/NYSE rule changes NYSAG reaches settlement with Merrill Lynch Sarbanes-Oxley Act signed SEC proposes Regulation AC NASD/NYSE issue additional rules for research NASD issues further rule changes Preliminary settlement with major investment banks SEC approves Regulation AC Global settlement with major investment banks NASD/NYSE issue additional rules for research	June 2001 July 2001 February 13, 2002 May 8, 2002 May 21, 2002 August 2, 2002 July 30, 2002 October 3, 2002 December 2002 December 19, 2002 February 6, 2003 April 28, 2003 May 22, 2003

While concerns about research analysts' conflicts of interest have generated attention on a global basis, the debate over the topic has been the most vigorous in the U.S. with market participants, regulators, Congress and the New York State Attorney General all contributing to the regulatory framework that is emerging. The first serious effort on this issue began in late 2000, when the Securities Industry Association convened an ad-hoc committee composed of the heads of research of the major investment banks located in the U.S. that was charged with developing a set of "best practices" for research related conflicts of interest. Issued in June 2001, after lengthy and often tortuous negotiations with market participants, SIA's best practices served as a template for similar efforts in a large number of other jurisdictions. In the U.S., however, the private sector's effort to establish and maintain "best practices" was soon overtaken by other events.

On the regulatory side, NASD began to examine the need for more extensive regulations regarding research related conflicts of interest in early 2001. That project took on added urgency during the course of the year as the U.S. Congress held a series of high-profile hearings investigating research analysts' conflicts of interest and the New York State Attorney General's office released, as part of its own ongoing investigation, a series of damaging e-mails written by several prominent equity analysts during the late 1990s.[3] Both events had the effect of making research analysts' conflicts of interest front page news in the U.S., further complicating the regulators' task.

NASD and NYSE issued two sets of new regulations for research analysts and research related conflicts of interest in 2002, the first in March and the second in October.[4] The regulations include enhanced disclosure requirements as well as a large number of prescriptive rules. Among other measures, the new regulations prohibit investment banking from supervising research personnel, restrict analysts' ability to own and trade securities of the firms that they cover, impose quiet periods on research for firms that manage or co-manage a public offering and prohibit research analysts from participating in solicitation or "pitch" meetings with clients. The new regulations also require firms to establish compensation committees that will review and approve compensation packages for each analyst, with the committees expressly prohibited from considering the analysts' contribution to the firm's overall investment banking business when approving their compensation. In addition, the basis for each analyst's compensation must be documented and certified annually (**Table 2**).

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[3] New York State Attorney General Elliot Spitzer began to investigate allegations that research analysts had committed securities fraud in their research reports in mid-2001, beginning with an investigation into the practices of Merrill Lynch's equity analysts. The initial investigation resulted in a landmark settlement in May 2002, in which Merrill Lynch agreed to pay a $100 million fine and promised to: (1) separate research analysts' pay from the firm's investment banking business; (2) create a new committee to oversee the "objectivity" of stock ratings; and (3) establish a new system to monitor e-mails between investment bankers and equity analysts. Shortly after the settlement with Merrill, Saloman Smith Barney agreed to change the structure of its equity research department in a similar fashion. The SEC, NASD, NYSE and others eventually merged their ongoing investigations with the investigation by the New York State Attorney General, resulting in the global settlement that was announced on April 28, 2003.

[4] The SEC has approved the proposed regulations issued in March, while those that were issued in October have not yet been approved.

Table 2

Regulations for Research Analysts and Research Related Conflicts of Interest in the U.S.*

Disclosure Requirements

All disclosure must be prominently displayed on research reports
Firms must disclose holdings equal to 1% or more of any class of equity securities of subject company[1]
Firms must disclose if the subject company was a client of broker-dealer and types of services provided[2]
Firms must disclose if they make a market in the subject company's securities
Firms must disclose if they have managed or co-managed offering of subject company in past 12 months
Firms must disclose if they received investment banking fees from subject company in past 12 months
Firms must disclose if they or affiliates received other compensation from subject company in past 12 months[3]
Firms must disclose any other actual material conflict of interest relative to the subject company
Firms must disclose if research analyst is officer, director or board member of subject company
Firms must disclose if research analyst received compensation from subject company in past 12 months
Firms must disclose if research analyst received compensation from investment banking division
Firms must disclose any other material conflict of interest of the analyst relative to subject company
Analysts must disclose if firm has received compensation from subject company in past 12 months[3]
Analysts must disclose any personal financial interests in covered company and nature of those interests
Firms must disclose valuation methods used for research, the meaning of ratings and the risks involved
Firms must publish or otherwise disclose the overall distribution of ratings
Firms must disclose the percentage of rated securities that are rated "buy", "sell" or "hold"
Firms must disclose the percent of companies that are investment banking clients within each category
Reports must include a chart depicting the price of equity over time and points when ratings assigned
Research reports must contain information on price and ratings history of all rated securities
Firms must publish notice of their intention to suspend or discontinue coverage of rated issues
Firm must disclose for a specified period of time if it managed the subject company's IPO
Firms must disclose if a member of the analyst team owns shares in firm that is going public

Prescriptive Requirements: Strengthening "Chinese Walls" and Segmenting Research

Information barriers between research and business units must be maintained at all times
Reporting lines between research and investment banking must be clearly demarcated
Investment banking personnel cannot supervise research
Firms must ensure that material information obtained by research is retained within research department
Firms must have clear guidelines for managing potential conflicts of interests faced by analysts
Firms must have clear guidelines for analysts who make public appearances of all types
Firms must monitor compliance with guidelines for managing conflicts of interest[4]
Investment banking personnel cannot retaliate or threaten to retaliate against research analysts
Firms and employees cannot trade using unpublished information from research

*Includes both proposed and approved regulations.

1 Requirement covers holdings in the five days prior to publication of a research report or a public appearance by analyst that is covering the company.

2 Types of services that must be disclosed are investment banking services, non-investment banking securities-related services and non-securities services.

3 Must be classified as compensation derived from investment banking services, non-investment banking securities-related services and non-securities services. Disclosure must be made in written research and public appearances by research analyst.

4 Firms must certify annually that they have implemented measures to comply with all relevant SRO rules.

Table 2 (continued)

Prescriptive Requirements: Strengthening "Chinese Walls" and Segmenting Research (continued)

Non-research personnel and subject companies cannot approve research reports prior to publication[5]
Firm cannot publish research if analyst tried to obtain investment banking business from subject company
Firms cannot promise favorable research or a specific price target or offer to change a rating
Firms cannot publish or otherwise distribute research for 40 days after a primary offering[6]
Firm cannot publish or otherwise distribute research for 10 days after a secondary public offering[6]
Firm cannot publish or otherwise distribute research for 25 days after an IPO if it participated in an underwriting syndicate for the IPO
Firms cannot issue research for 15 days prior to and after expiration of a "lock up" agreement[7]
Research can notify an issuer of a change in rating only at a specific time
Research sent to a subject company prior to publication cannot include the rating or price target
Once coverage is initiated, any proposed rating change in an unpublished research report must be approved by compliance and legal if the subject company has reviewed the report
Research analysts are prohibited from participating in solicitation or "pitch" meetings with clients
Communication between non-research personnel and research must be through legal/compliance[8]
Analysts cannot be compensated with revenues from specific investment banking deals
A compensation committee at each firm is to approve annual compensation for research analysts[9]
Compensation committee cannot consider analyst' contribution to investment banking business
Analysts' compensation will be based on the quality and accuracy of his or her research
The basis for analysts' compensation is to be documented and certified annually to NYSE

Prescriptive Requirements: Improving Quality of Research and Analysts' Ethics

Ratings must be clearly explained and appropriately categorized
Supervisory analysts must be responsible for approving all research reports
Analysts and supervisory analysts must be registered with and qualified by NASD and NYSE
Analyst cannot trade securities of covered companies for 30 days prior to publication and 5 days after[10]
Analysts and family members cannot trade against their own recommendation unless authorized to do so
No analyst or family member can buy pre-IPO shares if the issuer is engaged in the same type of business that the analyst covers
Supervisory analysts must pass qualification examination
Management should periodically review all research and recommendations
Firms must keep research reports on file for a specified period of time
Continuing education to be required for analysts stressing rules, ethics and personal responsibilities[11]
Analysts must certify that they have not received compensation for specific recommendations
Research analysts must certify that the views they have expressed reflect their personal views

[5] Non-research personnel and the subject firm can only check unpublished research for accuracy.

[6] Applies to firms that have managed or co-managed primarily or secondary public offering of the subject company. Also applies to public appearances by research analysts covering the subject company.

[7] Restriction applies to firms that act as manager or co-manager and also covers public appearances.

[8] This regulation refers to communication regarding unpublished research.

[9] Compensation committee cannot include members of investment banking department.

[10] Restrictions apply also to family members of the research analyst.

[11] Also applies to supervisory analysts.

In addition to the rules issued by the SROs, the Securities and Exchange Commission issued a new rule for research analysts in August 2002. Formally known as Regulation AC, this regulation requires research analysts to certify: (1) that the views they expressed in written research accurately reflected their own personal views; and, (2) that their compensation was not directly or indirectly related to specific recommendations or views contained in their research reports or public appearances. The regulation also requires analyst to certify on a quarterly basis that the views they express in public appearances are their own views and that no part of their compensation was related to their specific recommendations. Regulation AC is broader in scope than the regulations issued by NASD and NYSE since it applies to both equity and fixed income research and also applies to research analysts based in foreign jurisdictions who are producing research for investors in the U.S.[5]

Along with the regulations issued for the industry as whole, additional regulations regarding research related conflicts of interest have been imposed on the financial services firms that were party to the "global settlement" reached between those banks and a coalition of regulators and law enforcement officials in April 2003.[6] Under the terms of the settlement the firms agreed to pay fines and other fees amounting to nearly $1.4 billion while also agreeing: (1) to impose a physical separation between their research and investment banking departments; (2) to create completely separate reporting lines, legal and compliance staffs and budgeting processes between research and investment banking; (3) that investment bankers will have no role in determining which companies are covered by the analysts; (4) that research analysts' compensation may not be based on input from investment banking personnel, who will have no role in evaluating analysts' job performance; (5) that an analyst's compensation will be based in significant part on the quality and accuracy of the analyst's research; (6) that analysts will be prohibited from participating in efforts to solicit investment banking business, including pitches and roadshows; and, (7) to implement policies and procedures reasonably designed to ensure that their personnel do not seek to influence the contents of research reports for purposes of obtaining or retaining investment banking business.

The financial services firms that were party to the global settlement in the U.S. also agreed to pay $80 million over the course of the next five years to fund independent research, which they must distribute to their customers and put on their own websites. This requirement, which in effect forces the banks to subsidize the activities of independent research houses, is intended as a way to ensure that retail investors will have different sources of research available. It remains a highly controversial proposal since, as numerous critics have pointed out, the requirement will raise costs to clients without any guarantee that the research produced will be an improvement over the firms' own research.[7] In part because of the uncertain benefits of this requirement, no other regulator has issued a similar proposal.

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[5] Currently, the regulations proposed and implemented by NASD and NYSE apply only to equity analysts. However, this situation may change in the future since the SEC has indicated that the SROs are studying when and how to broaden their rules so as to include fixed income research.

[6] The parties to the settlement on the official side included the SEC, NASD, NYSE, the New York State Attorney General, several other state attorney generals and the North American Securities Administrators Association. The securities firms that were party to the settlement included Bear, Stearns, Credit Suisse First Boston, Goldman, Sachs, Lehman Brothers, J.P. Morgan Securities, Merrill Lynch, Morgan Stanley, Citigroup (Salomon Smith Barney),UBS Warburg and U.S. Bancorp Piper Jaffray

[7] As the UK's FSA noted in a recent paper, an arrangement of this type will not necessarily produce high quality research since, "… the value and independence of a product paid for by a sell-side institution rather than the consumer, and which would be in competition with the institution's own research products, may be questionable." See Financial Services Authority, "Conflicts of Interest: Investment Research and Issues of Securities", Consultation Paper No. 171 (February 2003), page 26.

Finally, the SROs issued a third set of new regulations on the topic in May 2003, largely in response to mandates imposed by the Sarbanes-Oxley Act.[8] The latest set of proposed regulations are in many respect more stringent that the regulations issued during 2002, and include some of the restrictions imposed on the financial services firms that were party to the global settlement. Among other measures, the new regulations: (1) extend some restrictions on the relationship between research and investment banking to all non-research personnel; (2) require additional disclosure on the part of analysts and firms, including the disclosure of any non-investment banking relationship between the investment banking firm and the subject company; (3) prohibit financial services firms from publishing research if the research analyst attempted in any way to obtain investment banking business from the subject company; and, (4) impose a quiet period on firms that underwrite an initial public offering, which in addition to the quiet period that is already imposed on firms that manage or co-manage primary or secondary offerings.

Conclusions

U.S. regulations for research analysts and research related conflicts of interest have several objectives. First, the enhanced disclosure requirements are intended to ensure that retail investors understand the various conflicts that may affect the objectivity of research analysts' views. Second, the prescriptive measures are intended to substantially reduce the opportunities for conflicts of interest to emerge by: (1) strengthening existing "Chinese walls" between research and business units in integrated financial services firms; (2) regulating analysts' ability to own and trade securities of the firms that they cover; and (3) modifying the incentive structure in integrated financial services firms that may encourage the issuance of biased research. This last point is critical since, as many critics have pointed out, research is typically not able to finance itself but instead relies upon revenues from other areas of the firm, which research analysts may be able to influence by the issuance of research reports with a specific slant or bias. Although U.S. regulators have not forced integrated financial services firms to divest themselves of their research departments, as many legislators and others had demanded, the new regulations have the effect of separating research from investment banking as much as possible without formal divestiture.

One obvious benefit of the new regulations is an improvement in the integrity of the research process, since conflicts of interest between analysts' objectivity and their opportunities for material gain from the issuance of biased research are now much less likely to emerge than in the past. Since the regulatory framework for research related conflicts of interest in the U.S. is still evolving, however, it is far too early to evaluate the overall impact of the new regulations. It is not clear, for example, if greater integrity in the research process will translate into improved confidence in U.S. securities markets on the part of retail investors. At the same time, the new regulations will impose significant adjustment costs on integrated financial services firms, many of which used research as a means to attract and retain investment banking business during the 1990s. As this business model is no longer viable, research budgets and research coverage at these firms is already contracting, which could have an adverse effect on some firms and some market segments. The new regulations, which place significant restrictions on research analysts' ability to "go over the wall" in order to work with business units, may also impose additional costs on the capital raising process that may not be apparent until markets recover more fully. For all of these reasons, a full evaluation of the costs and benefits of the new regulations will only be possible once some period of time has elapsed.

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[8] Although the Sarbanes-Oxley Act dealt primarily with accounting fraud, it also included one section that mandated a number of new regulations for research analysts and research related conflicts of interest.

THE NEW YORK SECURITIES INDUSTRY
Wall Street's Importance to New York State and City

In 1994, SIA and the Robert F. Wagner Graduate School of Public Service, New York University co-authored a study, of the same title as above, which has been periodically updated ever since. The most recent 20-page update was issued this May as one SIA *Securities Industry Trends*, again with the same title (see: http://www.sia.com/reference_materials/pdf/NYTrendsMay03.pdf).

The following are some of the highlights from this report:

- Wall Street woes contributed to New York's chronic budget stress in the early 1990's, but then drove the State and City to surpluses from 1992 to 2001, seven of which were records. Now, another Wall Street recession is a major factor impacting New York budgets yet once again.

- Wall Street largely helped make New York State the equivalent of the eighth largest nation on earth based on GDP by 2000. From 1992 to 1999, Wall Street's boom accounted for nearly half (48%) of total growth in New York's Gross State Product.

- During the same bull market timeframe, the securities industry carried the state's growth rate, averaging 21.3% annually vs. an overall 3.1% statewide rate and a 1.8% growth rate for all other industries and government combined.

- For the eight years ending in 2000, the securities industry added 60,000 jobs in the state, from 157,000 at year-end 1992 to an all-time high of 217,000, a 38% increase. However, during the following nine quarters, more than half of that growth evaporated, resulting in a record loss of 38,000 jobs, or 18% statewide (down 19% in NYC), with further consolidation expected through mid-year.

- Since the stock market crash at the end of 1987 through last year, New York only added 7,100 new securities industry jobs, not even 3% of the 244,200 new industry jobs created in, or that were relocated to, the nation's other 49 states.

- However, New York still has double the securities industry workforce of its nearest competitor, California. New York also still accounts, as does the city, for more securities industry jobs than 42 other states combined.

- New Jersey alone more than tripled its securities industry workforce from 1990 to 2001, rising from fifth largest securities employer to #3. These are, in large part, highly paid, highly skilled former NYC jobs. New York would do well to encourage this type of job formation and retention.

- According to the 2002 U.S. Census, New York is ranked #2 behind only California in total taxes paid as well as state taxes paid. It also was 55% ahead of its next nearest "competitor," Texas, and far beyond double New Jersey's total tax burden. New York State also ranked #2 in combined state and local tax burden as a percent of income at 12%, well ahead of the national average of 9.7%.

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